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Congressional Testimony

Testimony of

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Policy makers at all levels of government but particularly at the federal level have a number of “prime directives” that govern their work: design and run efficient programs, change policy in line with the changing world in which the policy lives, listen to citizens and their elected representatives, and do no harm. Within this list, clearly the last ranks highest. At the risk of using an inappropriate analogy, the cure must not be worse than the disease.

In the arena of public policy dealing with financial markets and the information instruments that are so vital to those markets, there is little controversy among economists as to the public sector’s principal policy duty. Policy makers should pursue means that encourage the growth of information systems that support vibrant financial markets where relatively low-risk experimentation with new companies and products can take place. Sound financial markets turn on sound financial information.

Doubtless the most profound change in financial market regulation occurred with passage of the popularly titled Sarbanes-Oxley legislation in 2002. Congress enacted this legislation to address the succession of corporate financial scandals that began with Enron in 2001 and grew with revelations of financial wrong doing at Global Crossing and WorldCom. The legislation was surrounded by an emotional debate over the fate of these important companies and their employees and the worsening recession that began just as the scandals were breaking.

There’s an adage in law that says hard cases make bad law. Today analysts are acquiring evidence that the reaction of Congress to transitory financial market problems and to the enveloping recession created law and subsequent regulation that has harmed markets, the creation of new businesses and consumer well being, and the general level and quality of U.S. economic activity.

As described below, our own research indicates (though it does not prove) that Sarbanes-Oxley may have had a negative effect on the volume of private equity deals independent of the influence of a poorly performing economy that surrounded investment decisions in the first two years following passage of the Act.

The key ingredients to a well-functioning, dynamic system of financial markets are financial information and entrepreneurship. There are hardly any two factors more important, unless it is the sheer volume of new business ideas and supporting entrepreneurial activity that produce markets in the first place. While regulators will certainly nod in the direction of high-quality information (and, indeed, the inspiration of Sarbanes-Oxley rose from the desire for better information) and entrepreneurship, many policy makers and regulators have an incomplete appreciation of how markets use information and depend on knowledge.

Investors who enter a financial market obviously are unable to know everything about a company’s stock they are thinking about buying. They cannot know about

unrecorded conversations that have taken place between company executives concerning the business's future prospects. They cannot obtain without great difficulty the information they would want about the company's suppliers or customers or, indeed, other investors. Even if they could obtain written information about all of these things, that information would be significantly outdated by the time the investor buys the stock. The company executives conceivably could totally change their view of the company's prospects, suppliers could depart in mass on the basis of some rumor the day after the investor gets his or her information, or customers could decide that this company's product is the next big thing and swing toward it overnight.

Given these obstacles to getting obviously important information, it is amazing that anyone buys stocks and company bonds. Imagine the enormous risk of failure from significant lack of failure that investors would face if that had to rely solely on their own ability to collect these kinds of data. Imagine how few investments would be made if some other information system failed to be in place.

Fortunately for financial markets, such a "good-enough" information system is working all of the time. It is called the price system, and it provides highly reliable signals about a host of developments that otherwise would be impossible to obtain. Thousands of investors daily look at the same company and supply information to financial markets by their decisions to buy, sell, or hold company stocks and bonds. An individual investor doesn't need to know the internal company gossip about a big, lost contract to sense that a steeply declining stock price signals some kind of problem. The investor may just want to invest in, say, technology companies; and he or she accomplishes this end by purchasing interests in a technology mutual fund, and will buy or sell based on the direction of the fund's price. In this instance, the price system allows successful investment without hardly any information about individual companies.

The virtually unimaginable economic gains that come from relying on price movements for information rather than "hard" data makes the defense of a well-functioning price system one of Congress's top priorities. I say "defense" because the price system is almost a natural resource, and it is as worthy of preserving as our water and air. Government certainly didn't create it, and there appears to be no moment in history when it suddenly emerged. Rather, it is a natural part of human life and, as such, central to our social and economic future.

It can, however, be harmed by government. While no one denies that good reporting of financial results is important to market performance (honest 10ks are preferred over dishonest ones), markets can punish crooked companies faster and more severely than courts or legislatures. In fact, the price system can move so swiftly against a business that some stock exchanges have rules that stop trading in a company's equities when prices fall by a certain percentage over a certain time period.

Government oversteps its duty to defend the price system when it imposes laws and regulations that create uncertainty or significant additional compliance costs. Uncertainty and additional costs get built into the price of stocks and bonds as regulatory

premiums. That is, a regulation that has an uncertain effect or interpretation creates a risk that company management may not have fully complied with the government's requirements. Investors will demand higher returns in the short-term to compensate them for potentially lower returns in the future following the imposition of regulatory penalties. This investor demand for higher returns is reflected in the stock's price, which is discounted for risk.

If these government risk premiums are great enough, they can substantially distort market prices. When such distortion occurs, the vital information that investors need for efficient decision making is either obscured or lost.

There is increasing anecdotal and statistical evidence that Sarbanes-Oxley has created damaging distortions to the price system. Our own research on this possibility has focused on changes to venture capital funding after passage of SarBox. Venture capital funding reflects all aspects of the problem described above: entrepreneurial activity, capital costs, investor decisions, financial reporting requirements, and (in some cases) publicly traded equities. If Sarbanes-Oxley appears now to exercise a deleterious effect on financial markets, the venture capital industry should provide an early indication of that effect.

The staff of the Center for Data Analysis collected monthly data on venture capital deals from 1995 onwards. Our data came from Thomson Financial Services' *Venture Economics* website. These data included the volume of deals and their total value. Data also were assembled from other CDA economic models on the US economy. After all, the venture capital industry was severely affected by the collapse of the dot com bubble in the fall of 2000 and winter of 2001. That time period also saw the debate over more financial regulation heat up. Thus, the key analytical problem faced by my staff was distinguishing statistically the effects of the recession on venture capital deals from the effects of Sarbanes-Oxley.

We addressed this problem by constructing a model that attempts to explain the change in private equity deals¹ by following changes in an indicator for the economy (in this case employment), change in the S&P 500, prior private equity deals, and indicators for various time periods, one of which is the period following the passage of Sarbanes-Oxley.

The analytical results from running this model of private equity deals appears to confirm the anecdotal evidence that Sarbanes-Oxley reduced the volume of deals. We are currently updating the model with new and more recent data, and will report our revised results to the Committee when they become available later in the summer.

We also tested the same basic model, with the appropriate number of time period lags, for two additional measures: fund commitments and initial public offerings (IPO)

¹ Private equity deals is defined as the universe of all venture investing, buyout investing, and mezzanine investing, which is a fund investment strategy involving subordinated debt, or the level of financing senior to equity and below senior debt.

of venture firms. *Venture Economics* defines “Fund Commitments” as a limited partner’s obligation to provide a certain amount of capital to a fund. IPO data are monthly time series from January 1970 and the commitment data are quarterly time series from the first quarter of 1980.

Using these measures, the estimates on the time indicator for Sarbanes-Oxley were all negative, but the overall results are not as reliable as those found using private equity deals. Two of the main reasons for this disparity are the data: the IPO data only represent the *Venture Economics* IPO universe, and the commitment data span a shorter time period with a lower frequency (quarterly vs. monthly). For all of these measures, the time period variables were found to be negative, but of a smaller magnitude with a larger standard error. We believe that these results also will become more robust with the addition of new data.

Economists can provide the inferential and general evidence that confirms what you hear anecdotally. That is, we have some evidence that Sarbanes-Oxley reduced venture capital activity, possibly by increasing the risk premium on investment because of the uncertainty surrounding what the law would require.

If this statistical evidence grows as more data become available, and other researchers find similar effects in other parts of the financial sector; then policy makers will find themselves better able to assess the costs and benefits of Sarbanes-Oxley. Due to the linkages between changes in investment and in employment and wages, this body of evidence may soon be sufficiently weighty that debate over the future of Sarbanes-Oxley will spill out of the policy circles in Washington and into the general political discussion over the economic future of the country.